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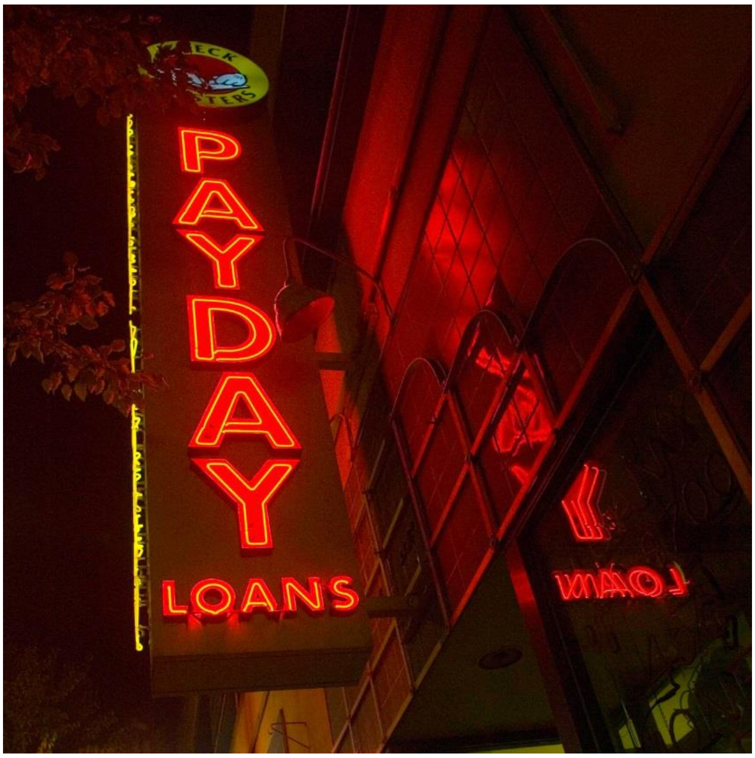
After payday lending: Accessible and affordable credit



Jeremy Peat, Visiting Professor, International Public Policy Institute

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POLICY BRIEF

After payday lending: Accessible and affordable credit

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I Introduction

If there is one feature which defines the economically disadvantaged it is the sheer difficulty and cost of accessing affordable credit. This was a topic I helped to explore in some detail as co-chair of a short term working group established by the Carnegie UK Trust. We reported earlier this year.[1] The Group's report includes the following 'Outcome Statement'- what we believed should and could be achieved:-

> All citizens in Scotland, wherever they live, have access to excellent forms of community lending which helps them to reduce the costs of borrowing and supports their financial inclusion, promotes fairness and reduces inequality.

In the report we also state firmly that 'Affordable loans are not a substitute for decent wages or a decent welfare system. The wider supply of more affordable credit is one part of a package towards creating a more socially just society.'

Progress in this direction is now well underway but achieving the desired full outcome remains an aspiration and one which will take time and much wise and well-informed effort to achieve. The reason why, following my suggestion, the working group was established on a short term basis was to avoid the risk of the group getting bogged down in the wealth of difficulties and complexities to be uncovered by all who attempt to make progress in this area. We needed to point towards a positive and achievable path forward. Consequently our report included a number of specific proposals, including the need for further requirements for progress and action to be identified and progressed by a high level action group.

The Affordable Credit Action Group for Scotland has now been established under the chairmanship of the Very Reverend John P Chalmers, Principal Clerk to the Church of Scotland. John Chalmers was a very influential and engaged member of the short term working group; and under his influence (first as Convenor of the General Assembly and now as Chief Clerk) the Church of Scotland has been immensely supportive of all endeavours.

I have decided, given my previous role of co-chair of the working group, to stand down from the Action Group. However, I remain fully committed to its objectives and efforts. Indeed I very

[1] See 'Gateway to Affordable Credit' the Report of the Affordable Credit Working Group; February 2016. Copies are available from the Carnegie UK Trust. The other co-chair was Angus Hogg MBE, Chair of Carnegie UK Trust.

much hope (and expect) that over its period of existence (anticipated to be two years) major strides forward can be made so that more and more people in Scotland from relatively disadvantaged backgrounds can have access to fairly priced short term credit at short notice. Such progress would make a major contribution to enhanced economic welfare and inclusive growth across Scotland.

II The nub of the problem

Providing access to short term credit, at short notice, in relatively small packets, to people with extremely limited credit records is (inevitably) expensive. However, there is a significant demand for such access, both to deal with unexpected problems and at times of particular financial stress – Christmas, birthdays, starts of the school year, etc. Access to such credit really matters for a very large number of people in Scotland.

III The decline of payday lending

Various more and less legal sources of such credit have developed over the years. In recent years particular attention has been focussed on the operations of Payday Loan companies, which had captured a high share of this market. Following investigations by the Competition Commission[2] and others, caps were placed on the interest rates (generally measured as APRs) which these companies are permitted to charge. As a consequence they have moved to concentrate on demand from less disadvantaged groups, intrinsically lower risk, near prime rather than sub-prime borrowers, and hence areas of lending where acceptable (to the companies) profit margins can be maintained, while operating within the interest rate cap.

As a consequence, they have tended to move away from offering credit to the more disadvantaged, where (inevitably) risks are higher and margins lower, leaving the more disadvantaged to seek credit, as and when required, from alternative legal and illegal sources. Such sources are generally (not universally) even more expensive and less satisfactory than the Payday Loan companies themselves. The quite understandable move to cap seemingly grossly excessive costs of borrowing has led to the unintended consequence of making access to credit for many disadvantage people less available and/or more costly than before.

IV Alternative sources of accessible and affordable credit

The key question, therefore, addressed by the Working Group, and being followed up by John Chalmers and his Action Group is how this problem can be resolved. How, in an inherently expensive arena, can credit be made available as required, often at short notice, to disadvantaged groups at acceptable rates of interest? It is clear that such credit will not be cheap, will not be on terms comparable to what is available for those with higher and more

[2] Now the Competition and Markets Authority.

reliable income streams and better credit histories. But it must be seen as fair and reasonable, avoiding unreasonable and 'excessive' profits being earned by the providers.

The solution will not be found, except in small part, among the traditional financial service sector. This statement should not be seen as a criticism of that sector. While both the major and the 'challenger' banks are striving to provide so-called 'basic bank accounts' on reasonable terms, they are not established on a basis that makes them appropriate for providing the type of credit we are discussing in this paper.

Achieving access to a basic bank account may be a desirable aspiration for many on lower incomes; but loans from major or challenger banks will not be an immediate or short-term solution for the majority of those who had been the customers of the Payday Loan companies. They will need to find alternative routes to access credit, preferably via organisations which can also assist with wide financial management advice such that the demand for the most expensive credit is diminished over time.

We identified two key sources of affordable credit which merited further investigation and support from public, private and third sector sources. These were Credit Unions (CUs), a relatively powerful sector across Scotland, and the Community Development Finance Institutions (CDFIs) – of which there is only one example in Scotland, the award-winning Scotcash based in Glasgow.

Both CUs and CDFIs clearly must have key roles to play in enhancing the availability of suitable forms of affordable credit[3]. In our report we set out various proposals and recommendations which I believe that the Action Group is following up as urgent priorities. The Action Group must incorporate and have close working relations with key and influential representatives across the sectors. Further key parties in both public and private sectors must commit to contributing support and resources of various types so that CUs and CDFIs can move rapidly to help to fill the affordable finance gap which continues to exist across Scotland.

V The key challenges

- It is vital that all who could be involved in this sector recognise that provision of the type of credit under discussion is inherently expensive and that will be reflected in the interest rates which have to be charged. The cost will be high because
  - (a) small amounts are involved
  - (b) generally at short notice
  - (c) to low income/low wealth individuals and households

[3] There is limited commentary on CUs in this note. That is not intended to understate their importance. One issue, for some but not all CUs, is that they require members to save for a specified period before they can borrow. That may rule out many with a sudden and urgent need for a small loan. Also there are caps on lending rates for CUs which may rule them out of the expensive lending area under discussion.

  - (d) with thin and/or poor credit history'; implying
  - (e) the desirability of face-to-face meetings prior to credit approval
  - (f) often with the prospect of some flexibility (e.g. payment holidays) being requested and despite best endeavours all around
  - (g) higher than standard risks of default.
- It will take a considerable period of time, measured in years not months, for any new CDFI to reach financial viability on an 'ongoing' basis.
- During the start-up phase there will be a necessity for 'soft' finance – grants or very low cost loans.
- But the CDFI must always be established on the basis that it will reach financial viability by some foreseeable time, in other words that it will be able to operate, after the early years, on the basis of commercial funding alone. This is a challenging but essential requirement.
- The new providers of affordable credit must not see themselves as isolated entities. They have to be seen as part of the financial sector, and in particular to have links to the retail banking sector such that they can act as a gateway to financial inclusion. For some CDFI customers the objective should be for them to be 'moved on' to financial inclusion, e.g. via a basic bank account and/or a continuing relationship with a Credit Union.
- The clear implication is that those likely to get involved will be socially rather than purely commercially motivated. This is a complex combination. The CDFIs, etc. will be operated to achieve social 'inclusion' objectives but have to be operated efficiently and 'commercially' so as to achieve the essential financial viability and hence sustainability.
- Local authorities are likely to have a major role to play, and support from central Government will be critical. But both must accept that high (definitely double digit) interest rates will be charged and that this is a necessary part of achieving the objectives rather than some financial 'rip off'.

VI Progress is underway!

Following the report of the working group which I co-chaired two major steps were taken by Carnegie, in addition to but consistent with the establishment of the new group led by John Chambers. First, they committed £100,000 to actions to support the group and its activities over the period 2016-18. Second, they appointed Niall Alexander[4] as the Carnegie Associate on Affordable Credit, to work on our reports recommendations and support the new group.

There are already strong indications of local authority activity. Fife, West Lothian and Falkirk Councils have agreed to commit nearly £1 million of grant and loan funding to establish a CDFI

[4] Niall had been closely involved with the working group and had impressed us all with his close knowledge of this sector (he had worked advising local authorities and others) and his commitment. In addition he had worked as Development Director of the CDFI Moneyline and had been Director of Financial Inclusion at the Bank of Scotland. He is an excellent choice for this new role.

across their local authority areas.[5] Further support has been provided to these councils by the Action Group and the Carnegie Associate. The latest development is that these councils have now formally launched their Invitation to tender for 4 new CDFI outlets, with closing date for bids at end of November.[6]

Further Renfrewshire Council is establishing a local partnership to explore the area of affordable credit; and North Ayrshire is highly active and considering the provision of affordable credit via a 'CDFI-Plus Model' to be delivered by the local credit union. This initiative should be watched with close attention.

Meanwhile attention is also being paid to Scotcash[7] – referred to earlier as Scotland's only personal lending CDFI active in this area. Niall Alexander is helping them to consider if their reach can be extended to other communities and cities in Scotland – from their present Glasgow base. I would note that this must not put at risk their financial sustainability – they are closing in on viability just now – but demand for affordable credit is not limited to certain areas. The characteristics of the Scotcash borrower are found throughout Scotland.

More breaking news is that the Scottish Government has published its high profile Fairer Scotland Action Plan including a commitment to take action to widen access to affordable credit. Commitments from Virgin Money[8] and Carnegie to work on this issue are included as part of Plan.[9]

VII But there is plenty more to achieve!

One critical area where I know the Associate and the Action Group are active is relations with the credit union and banking sectors. The scaling up of the CU sector to offer affordable credit across a spectrum that includes lowest income and low to middle income borrowers via payroll deduction, with our biggest employers, will support their development. This is an active area of investigation for the Action Group.

It is important that CDFIs and evolving Credit Unions enhance their links with banks so that the different institutions are working as closely together as feasible. Face to face meetings with the chief officers of banking partners will help to identify 'invisible barriers' inhibiting the access from disadvantaged communities to basic bank accounts. Reducing and indeed removing these barriers must be in the mutual interest of the banks, the affordable credit institutions and a host of individuals.

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[5] This is a follow up to an excellent report for the councils prepared previously by Niall Alexander during his period as an independent consultant.

[6] http://www.publiccontractsscotland.gov.uk/search/show/search_view.aspx?ID=OCT261978

[7] It should be noted that RBS has been a strong (moral and financial) supporter of Scotcash for a number of years.

[8] Virgin participated in the working group, as did RBS and the Bank of Scotland.

[9] http://www.gov.scot/Publications/2016/10/9964/downloads

In addition these banks should be strong supporters of new CDFIs and evolving CUs. Their support can come via technical assistance, training staff, helping with credit risk assessment, payment systems, etc., and (to be blunt) cash.

The grant and soft loans required to achieve start up and ease the path to viability could come from various sources. Banks may well be one of these alongside lottery funding and foundations of different types. Further the involvement of key banks in new start-ups will add greatly to their credibility and increase the prospects of sustainability being achieved.

I have made limited reference to the Scottish Government. We cannot expect significant funding from that source. What can be expected is strong support and every effort to ensure that unnecessary and inappropriate barriers are not placed in the way of the path to a network of affordable credit agencies across Scotland.

VIII In conclusion

It now looks distinctly possible that strong progress can be made through 2017 and 2018 to achieve the outcome statement set out at the beginning of this paper. This would be a huge contribution to financial inclusion and to the reduction of inequalities in our society. It is difficult to overstate the potential impact on the wellbeing of many in our nation.

Because of the work of Carnegie, the Church of Scotland and other committed individuals and organisations Scotland is ahead of the game on affordable finance. Carnegie and the Action Group deserve our highly enthusiastic support and encouragement. The end prize is of real substance.

About the author:

Jeremy Peat OBE is a Visiting Professor at the International Public Policy Institute at the University of Strathclyde. He is as an economist and economic commentator and was Group Chief Economist at the RBS (Royal Bank of Scotland) from 1993 to 2005. He is a Board member of Scottish Enterprise, Chair of the Royal Zoological Society of Scotland and was a long-standing Director of the David Hume Institute (2004-14). He is a fellow of the Royal Society of Edinburgh, of the Chartered Institute of Bankers and the Royal Society of Arts. He is a regular commentator on economic and wider public policy issues and writes a monthly column for the Herald newspaper.

Contact details:

Jeremy Peat
Visiting Professor, International Public Policy Institute
University of Strathclyde

e: jeremy.peat@strath.ac.uk

International Public Policy Institute (IPPI)
McCance Building, Room 4.26
University of Strathclyde
16 Richmond Street
Glasgow G1 1XQ
t: +44 (0) 141 548 3865
e: ippi-info@strath.ac.uk

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